No. 82-1200

IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

DAILY INCOME FUND, INC. and REICH & TANG, INC.,
Petitioners,

v.

MARTIN FOX

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MOTION FOR LEAVE TO FILE BRIEF, *AMICUS CURIAE,*

and

BRIEF, *AMICUS CURIAE,* OF THE INVESTMENT COMPANY INSTITUTE

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MOTION FOR LEAVE TO FILE BRIEF, *AMICUS CURIAE*

Pursuant to Rules 36.3 and 42 of this Court's Rules, the Investment Company Institute (the "Institute") hereby respectfully moves for leave to file the attached brief, *amicus curiae*, in the above-captioned case. The petitioners have consented to the filing of such a brief; the respondent has declined to consent to the filing of this brief.

The Institute is the national association of open-end investment companies (otherwise known as mutual funds), their investment advisers and their principal underwriters. The Institute has 884 investment company members with approximately 16 million shareholders, and assets of approximately $264.5 billion. The Institute is generally recognized as the primary spokesman for the mutual fund industry and, as such, was intimately involved in the 1970 legislative enactment of Section 36(b) of the Investment Company Act of 1940, the statute principally involved in this action.

The decision below articulates an unprecedented and damaging theory of the role independent mutual fund directors were intended to perform. If left unchanged, that decision will permit needless, costly, ill-founded and potentially abusive litigation against the members of the Institute. Leave of this

Court is sought to offer the Institute's unique perspective on the proper resolution of the important issues raised by the parties, so that the decision in this case can most effectively be reconciled with the structure and purposes of the Investment Company Act and Rule 23.1 of the Federal Rules of Civil Procedure.

For the foregoing reasons, the Institute should be permitted to file the attached brief, *amicus curiae.*

Respectfully submitted,

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QUESTION PRESENTED

The Institute adopts, by reference, the question presented by the petitioners:

> Is a shareholder's derivative action under Section 36(b) of the Investment Company Act of 1940 exempt from the director demand requirement of Rule 23.1 of the Federal Rules of Civil Procedure?

TABLE OF AUTHORITIES

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ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF OF THE INVESTMENT COMPANY INSTITUTE

The Investment Company Institute (the "Institute") files this brief, *amicus curiae,* in support of the petitioners' prayer that the judgment of the United States Court of Appeals for the Second Circuit, entered on October 26, 1982, be reversed.

INTEREST OF THE INVESTMENT COMPANY INSTITUTE

The Institute is the national association of open-end investment companies (otherwise known as mutual funds), their investment advisers and their principal underwriters. The Institute has 884 investment company members, with approximately 16 million shareholders and assets of approximately $264.5 billion. The assets of the Institute's members account for over 92 percent of the total assets of the mutual fund industry. The Institute's mutual fund members are registered with the United States Securities and Exchange Commission (the "SEC") under the Investment Company Act of 1940, as amended, 15 U.S.C. §§80a-1, *et seq.*, and are subject to detailed statutory prescriptions regarding their structure, operations and governance.[1]

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[1] *See, e.g., Burks* v. *Lasker,* 441 U.S. 471, 478 (1979); *United States* v. *National Association of Securities Dealers, Inc.,* 422 U.S. 694, 705 n. 13 (1975).

The Institute is concerned that the decision below will undermine the statutory role of independent mutual fund directors, and will permit needless, costly, ill-founded and potentially abusive litigation against mutual funds and their investment advisers.

For the reasons set forth below, the Institute respectfully submits that the decision of the Court of Appeals is incorrect as a matter of law, because it contravenes the express language employed by Congress regarding mutual fund shareholder litigation of the type involved here, and because it is inconsistent with the provisions and policies of *both* the Investment Company Act and the Federal Rules of Civil Procedure.

OPINIONS BELOW

The opinion of the Court of Appeals (per Kaufman, J.) (A. 23a)[2] is reported as 692 F.2d 250 (C.A. 2, 1982). The opinion of the District Court (per Duffy, J.) (A. 11a) is reported at 94 F.R.D. 94 (S.D. N.Y., 1982).

JURISDICTION

The judgment of the Court of Appeals was entered on October 26, 1982. A timely petition for a writ of certiorari was filed on January 17, 1983, and was granted on March 7, 1983. The Court has jurisdiction pursuant to 28 U.S.C. § 1254(1).

STATUTES AND RULES INVOLVED

Sections 15 and 36(b) of the Investment Company Act of 1940, as amended (the "ICA" or the "Act"), 15 U.S.C. §§ 80a-15 and -35(b), and Rule 23.1 of the Federal Rules of Civil Procedure ("Rule 23.1"), are relevant to the disposition of this action.

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[2] References to the Joint Appendix filed in this Court are cited as "A. ."

STATEMENT OF THE CASE

This suit was commenced on April 30, 1981, by Martin Fox, a shareholder of petitioner Daily Income Fund, Inc. (the "Fund")—a Maryland corporation which is an open-end investment company (or mutual fund) registered with the SEC (A. 5a-6a). Characterizing his suit as a "*derivative* action brought under § 36(b) [of the ICA]," [3] the plaintiff's complaint (A. 5a) stated, as expressly required by ICA Section 36(b), that the action was brought *solely* "on behalf of the Fund," and challenged the level of advisory fees paid by the Fund to its investment adviser, petitioner Reich & Tang, Inc.[4] Consistent with the "derivative" nature of his lawsuit, the plaintiff sought relief *exclusively for the Fund,* and not on his own behalf, save for his request for costs and attorney's fees (A. 8a).

As required by the ICA, the Fund's payment of advisory fees to Reich & Tang was governed by an explicit advisory contract, which specified the services Reich & Tang was to perform, and the level of fees Reich & Tang was entitled to receive.[5] The contract was approved by a vote of a majority of the Fund's outstanding shares [6] and, as also required by statute, has thereafter been subjected to annual review, evaluation and approval by the Fund's five directors, three of whom are independent, or disinterested, directors within the meaning of

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[3] *See* Plaintiff's Memorandum in Opposition to Motion to Dismiss, at 3 (emphasis supplied).

[4] The complaint does not specify which fees are challenged, or in what amount. By statute, however, the plaintiff's claims must be limited to some portion of the advisory fees paid from May 1, 1980, to April 30, 1981. *See* ICA Section 36(b)(3), 15 U.S.C. § 80a-35(b)(3).

[5] *See* ICA Section 15(a), 15 U.S.C. § 80a-15(a); Proxy Statement of Daily Income Fund, Inc., filed with the SEC on September 21, 1981, at 11, Exhibit A (hereinafter "1981 Proxy Statement").

[6] *See* Proxy Statement of Daily Income Fund, Inc., filed with the SEC on September 12, 1980, at 6 (hereinafter "1980 Proxy Statement").

the Act.[7] The Fund's advisory contract with Reich & Tang also provides, as required by law, that the Fund may terminate the agreement at any time, for any reason, without any penalty, upon sixty days' written notice.[8]

The plaintiff's complaint does not dispute that Reich & Tang has performed the services it contracted to perform, nor does the complaint dispute that the independent directors have annually reviewed, evaluated and approved the Fund's advisory contract with Reich & Tang. Instead, the complaint challenges only the wisdom of the judgment, approved by the Fund's other shareholders, and thereafter annually reconfirmed by the Fund's directors, that the advisory contract was and is fair to the Fund and in its best interests.[9]

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[7] *See* ICA Sections 15(a)(2) and 15(c), 15 U.S.C. §§ 80a-15(a)(2) and -15(c). A director is deemed to be disinterested, within the meaning of the Act, if, *inter alia*, he does not own or control, directly or indirectly, five percent or more of the outstanding shares of the fund, has no affiliation with the investment adviser, and has no prior business or professional relationship with the fund. *See* ICA Sections 2(a)(3) and 2(a)(19), 15 U.S.C. §§ 80a-2(a)(3) and -2(a)(19).

The three disinterested directors of the Fund are W. Giles Mellon, Professor of Business Administration in the Graduate School of Business Administration, Rutgers University; Alan J. Patricof, head of a private investment corporation; and Dr. Yung Wong, managing director of a venture capital firm. *See* Defendant's Affidavit in Support of Motion to Dismiss, at 2.

[8] *See* 1980 Proxy Statement, at 7; 1981 Proxy Statement, at 13. *Compare* ICA Section 15(a)(3), 15 U.S.C. § 80a-15(a)(3).

[9] Under the ICA, a majority of a mutual fund's shareholders must initially approve an advisory contract; for subsequent annual approvals of the contract, the statute requires a vote of a majority of *either* a fund's shareholders *or* a fund's board of directors, *and* approval by a majority of a fund's *independent* directors. *See* ICA Sections 15(a)(2) and 15(c), 15 U.S.C. §§ 80a-15(a)(2) and -15(c).

In this case, after receiving initial approval from its shareholders for the Fund's advisory contract with Reich & Tang, the Fund has disclosed each year to its shareholders the terms of the agreement and the fees paid to Reich & Tang under it. *See* Proxy Statements of Daily Income Fund filed with the SEC on October 17, 1975, at 5-7; August 30, 1976, at 3-5; August 29, 1977, at 3-4; September 1, 1978, at 6-8; August 31, 1979, at 5-6; September 12, 1980, at 6-7.

Despite the fact that his suit was filed "on behalf of the Fund" (A. 5a), and despite the fact that the majority of the Fund's directors are disinterested, the plaintiff eschewed the longstanding equitable mandate now embodied in Rule 23.1 that intracorporate remedies be exhausted prior to the commencement of a suit brought to vindicate corporate, as opposed to individual, rights. The plaintiff purported to justify his failure to comply with Rule 23.1 by asserting, first, that demand was excused, *as a matter of law*, in *any* action under ICA Section 36(b), and by asserting, alternatively, but without explanatory detail, that in this case "all of the directors are beholden to [Reich & Tang] for their positions and have participated in the wrongs complained of in this action" (A. 8a).[10] Deprived of any opportunity to evaluate and determine how best to resolve the plaintiff's charges, the Fund moved to dismiss the complaint for failure to comply with the prescriptions of Rule 23.1 (A. 1a).

Based on its examination of the Act and its legislative history, the District Court concluded that, absent exceptional circumstances not alleged here, demand is a prerequisite to a shareholder's derivative action under Section 36(b) (A. 15a). 94 F.R.D. at 96. Noting that Congress had intended that "the board of directors is to be the first line of defense" for charges of self-dealing by a mutual fund's investment adviser, Judge Duffy held it was "not unreasonable" to require a shareholder "first [to] bring a problem to the board of an investment company . . .," since "[t]he unaffiliated directors can easily solve the problem (if it be real) without the need for litigation . . . " (A. 15a). *Id.*

On appeal, the Second Circuit reversed. It held that a mutual fund shareholder need ***never*** "afford the fund an opportunity to vindicate its [that is, the fund's] rights because," the court assumed, "such a [demand] requirement would [likely] be an empty, unfruitful and dilatory exercise" (A. 49a). 692 F.2d at 262.

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[10] As noted by this Court in *Burks* v. *Lasker, supra,* 441 U.S. at 485 n. 15, this allegation is inconsistent with the express provisions of Section 2(a)(19) of the ICA, 15 U.S.C. § 80a-2(a)(19).

Despite both the plaintiff's and the appellate court's recognition that the rights created under ICA Section 36(b) belong solely to the Fund, and despite the appellate court's recognition that a panoply of "informal methods of attempting to recoup excessive adviser fees . . ." may be available to the Fund and its independent directors, the court below held that, in order for the demand requirement to apply, a mutual fund must be able "to 'assert,' in a court, the same action under the same rule of law on which the shareholder plaintiff relies" (A. 29a & n. 7). 692 F.2d at 254 & n. 7. In the belief that the Fund could not have commenced its own suit, *pursuant to ICA Section 36(b)*—a belief contradicted by the other appellate courts to consider the same issue[11]—the court below held that the salutary "policy behind requiring demand" had been rendered "superfluous" (A. 46a). 692 F.2d at 261.

SUMMARY OF ARGUMENT

The demand requirement of Rule 23.1, a *sine qua non* to shareholder litigation, is premised upon the fundamental principle that the board of directors is responsible for overseeing the management of corporate affairs and, therefore, should be given the first opportunity to vindicate corporate rights. A corporation itself is in the best position to seek redress of a shareholder's grievance, perhaps without resort to litigation, and the demand requirement serves to protect a company from vexatious "strike" suits brought solely for their nuisance value. Given these salutary purposes of the demand requirement, a strong presumption exists that Rule 23.1 applies to *all* derivative actions.

The plaintiff has failed to demonstrate that Congress intended to deny the applicability of these principles to actions under ICA Section 36(b); in fact, the ICA's provisions and

[11] *See Grossman* v. *Johnson*, 674 F.2d 115 (C.A. 1), *cert. denied sub nom., Grossman* v. *Fidelity Municipal Bond Fund, Inc.*, ____ U.S. ____ 103 S. Ct. 85 (1982), *reh'g denied*, ____ U.S. ____, 103 S. Ct. 774 (1983); *Weiss* v. *Temporary Investment Fund, Inc.*, 692 F.2d 928 (C.A. 3, 1982).

legislative history demonstrate that Congress intended no such result. The board of directors of a mutual fund is primarily responsible for safeguarding fund shareholder interests, and is in a unique position to undertake measures to recover excessive fees, provided early notice is given to the board. For example, ICA Section 15 requires annual review of all advisers' contracts and permits a board of directors to terminate such contracts at any time without the payment of any penalty. Thus, the board can utilize the leverage of future fees to exact a return of past fees which may reap greater benefits to the fund and its shareholders than permitted under Section 36(b).

The legislative history of the 1970 Amendments to the ICA not only fails to overcome the presumption of Rule 23.1's applicability but, in fact, supports application of the demand requirement to Section 36(b) actions. Congress expressly intended that an investment company's unaffiliated board members be accorded a primary role in the management fee area, and Section 36(b) was meant to strengthen, not to undercut, this role. Perhaps even more important, Congress expressly assumed (and was so advised) that it could rely upon the requirements of Rule 23.1 as a means of avoiding the specter of a plethora of shareholder strike suits under Section 36(b).

The Court of Appeals held that, as a matter of law, Rule 23.1 was inapplicable to *all* shareholder suits under Section 36(b) because, in its view, the shareholder's action was not truly derivative within the meaning of Rule 23.1. This conclusion flies in the face of logic, legal precedent and the legislative history of the Act. The basis of a derivative action is a wrong to the corporation—the precise basis for an action under Section 36(b). The statute clearly states that the only rights that may be vindicated under its terms are rights belonging to the mutual fund, not to the shareholder asserting those rights.

Moreover, Section 36(b) is founded on the common law action for waste, an action firmly established to be derivative in nature. Section 36(b) provides a mutual fund shareholder no personal recovery; any sums awarded under the Act are

returned to the mutual fund's treasury. As in other derivative actions, dismissal of the suit or settlement by the plaintiff in a Section 36(b) action must be approved by the court, and the judgment, or settlement, is *res judicata*. Finally, the legislative history of Section 36(b) is replete with references to the "derivative" nature of an action under Section 36(b).

Application of the demand requirement here fulfills the fundamental policies of both the ICA and the Federal Rules of Civil Procedure. As this Court noted in *Burks* v. *Lasker, supra,* 441 U.S. at 484, Congress established the independent directors of a mutual fund as the primary "watchdogs" to protect the interests of mutual fund shareholders. The decision below would impermissibly "muzzle" these "watchdogs," and prevent them from performing their statutory mandate. Moreover, the independent directors of a mutual fund are in the best position to assess the merits of a shareholder's allegations. Timely compliance with the demand requirement enhances the capacity of these directors to resolve legitimate concerns without the need to resort to costly litigation, or to persuade shareholders who proceed in good faith that some claims are either unworthy of assertion or are inimical to the best interests of the mutual fund on whose behalf they are proposed to be asserted.

In short, no justification exists in the Act, its legislative history, relevant case law or public policy to support the decision of the Court of Appeals.

ARGUMENT

A SHAREHOLDER SUIT UNDER SECTION 36(b) OF THE INVESTMENT COMPANY ACT, LIKE ALL OTHER SHAREHOLDER DERIVATIVE ACTIONS, IS SUBJECT TO THE DEMAND REQUIREMENT EMBODIED IN RULE 23.1 OF THE FEDERAL RULES OF CIVIL PROCEDURE.

A. Exhaustion of Intracorporate Remedies Is A Fundamental And Necessary Prerequisite To The Privilege Of Instituting A Shareholder's Derivative Action.

Contrary to the assertion of the court below, full consideration of the important policies underlying the demand requirement now embodied in Rule 23.1 is hardly "superfluous." Indeed, we respectfully submit that such consideration is essential to the proper disposition of this case.

The stockholder's derivative action was created by the early equity courts to permit shareholders of a corporation to enforce a *corporate* right, or to prevent or remedy a wrong *to the corporation*, in certain, limited, cases where the corporation failed *and* refused (usually because the actual wrongdoers controlled the corporation) to take appropriate action for the corporation's own protection.[12] By its very nature, shareholder derivative litigation is extraordinary; it is one of the relatively few instances in which shareholders may be able to displace corporate directors in the management of corporate affairs. In creating a right of limited access to the judiciary by persons who, by definition, do not seek to vindicate their *personal* rights, the avowed purpose of the equity courts was, and is, to prevent inequity and injustice.[13]

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[12] *See, e.g., Ross* v. *Bernhard*, 396 U.S. 531, 534 (1970); *Cohen* v. *Beneficial Industrial Loan Corp.*, 337 U.S. 541, 548 (1949); *Koster* v. *(American) Lumbermens Mutual Casualty Co.*, 330 U.S. 518, 522 (1947); *Meyer* v. *Fleming*, 327 U.S. 161, 167 (1946); *Ashwander* v. *Tennessee Valley Authority*, 297 U.S. 288, 319, *reh'g denied*, 297 U.S. 728 (1936); *Hawes* v. *City of Oakland*, 104 U.S. 450, 460 (1882).

[13] *See, e.g., Hawes* v. *City of Oakland, supra*, 104 U.S. at 454, 460.

Of course, derivative litigation may itself engender inequity or injustice: among other things, it displaces and disrupts the normal management of corporate affairs,[14] casts aspersions on corporate directors,[15] enmeshes the corporation in potentially costly and protracted litigation,[16] and is capable of producing results that may be inimical to the best interests of the corporation taken as a whole.[17] As this Court noted in *Cohen* v. *Beneficial Industrial Loan Corp., supra,* 337 U.S. at 548, the evils and abuses that can be engendered by derivative actions are real and awesome:

> Unfortunately, [derivative actions] provid[e] opportunity for abuse which has not [been] neglected. Suits sometimes [are] brought not to redress real wrongs, but to realize upon their nuisance value. They [are] bought off by secret settlements in which any wrongs to the general body of share owners [are] compounded by the suing stockholder, who [is] mollified by payments from corporate assets. These litigations [are] aptly characterized in professional slang as "strike suits." And it [is] said that these suits [are] more commonly brought by small and irresponsible than by large stockholders, because the former put less to risk and a small interest [is] more often within the capacity and readiness of management to compromise than a large one.

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[14] *See, e.g., United Copper Securities Co.* v. *Amalgamated Copper Co.,* 244 U.S. 261, 264 (1917).

[15] *See generally,* Note, *The Demand and Standing Requirements in Stockholder Derivative Actions,* 44 U. Chi. L. Rev. 168, 168-72 (1976) (hereinafter "*Demand and Standing*").

[16] The corporation is a necessary party in a shareholder's derivative suit. *See, e.g., Ross* v. *Bernhard, supra,* 396 U.S. at 538; *Meyer* v. *Fleming, supra,* 327 U.S. at 167; *Price* v. *Gurney,* 324 U.S. 100, 105 (1945); *City of Davenport* v. *Dows,* 85 U.S. (18 Wall.) 626, 627 (1874).

[17] *See, e.g., Surowitz* v. *Hilton Hotels Corp.,* 383 U.S. 363, 371, *reh'g denied,* 384 U.S. 915 (1966); *Galef* v. *Alexander,* 615 F.2d 51, 57 (C.A. 2, 1980); *Landy* v. *Federal Deposit Insurance Corp.,* 486 F.2d 139, 146 (C.A. 3, 1973), *cert. denied,* 416 U.S. 960 (1974); *see generally,* J. Coffee & D. Schwartz, *The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform,* 81 Colum. L. Rev. 261, 308-09 (1981); *Demand and Standing, supra,* 44 U. Chi. L. Rev. at 168-72, 192-93.

For those reasons, this Court held, more than one hundred years ago, that a would-be derivative plaintiff must exhaust available intracorporate remedies before seeking redress in court:

> [The shareholder] should show, to the satisfaction of the court, that he has *exhausted all the means within his reach to obtain within the corporation itself, the redress of his grievances, or action in conformity to his wishes.* He must make an earnest, not a simulated effort, with the managing body of the corporation, to induce remedial action on their part, and this must be apparent to the court . . . . And he must show a case, if this is not done, where it could not be done, or it was not reasonable to require it.

Hawes v. *City of Oakland, supra,* 104 U.S. at 460-61 (emphasis supplied).[18]

The importance of this so-called demand requirement is difficult to overstate. Properly pursued, it can obviate the need for litigation, since the directors may be able to achieve a resolution of the alleged wrongs by negotiation or arbitration, or the directors may be able to persuade a shareholder (assuming the shareholder is proceeding in good faith) either that there is no merit to the claim or that the assertion of the claim is apt to do more harm than good *to the corporation.*[19] Since the rights to be asserted in a derivative suit belong, in every respect, *only to the corporation,* it is both necessary and appropriate that the corporation be given an early opportunity to evaluate the nature of its rights, and the proper methodology by which such rights should be asserted.[20]

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[18] *Accord, e.g., Wathen* v. *Jackson Oil & Refining Co.,* 235 U.S. 635 (1915); *Lewis* v. *Graves,* [Current Decisions] Fed. Sec. L. Rep. (CCH) ¶99,106, at 95,281 (C.A. 2, 1983); *Galef* v. *Alexander, supra,* 615 F.2d at 59.

[19] *See generally,* Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit,* 73 Harv. L. Rev. 746, 748-49 (1960), *and cases cited therein* (hereinafter *"Demand on Directors").*

[20] *See, e.g., United Copper Securities Co.* v. *Amalgamated Copper Co., supra,* 244 U.S. at 263-64; *Clark* v. *Lomas & Nettleton Financial Corp.,* 625 F.2d 49, 52, *reh'g denied,* 632 F.2d 894 (C.A. 5, 1980), *cert. denied,* 450 U.S. 1029 (1981); *Landy* v. *Federal Deposit Insurance Corp., supra,* 486 F.2d at 146; *see generally, Demand and Standing, supra,* 44 U. Chi. L. Rev. at 171-72, *and cases cited therein; Demand on Directors, supra,* 73 Harv. L. Rev. at 746-50.

B. The Application Of The Demand Requirement To Derivative Suits Under Section 36(b) Is Mandated By The Plain Language Of The Statute And Rule 23.1.

The substantive prerequisites to the maintenance of a shareholder's derivative action, first articulated by this Court in *Hawes* v. *City of Oakland, supra,* 104 U.S. at 460-61, are now embodied in Rule 23.1.[21] That Rule provides, in essence, that demand (or *justifiable* excuse for the failure to make demand) is a necessary condition precedent to the maintenance of shareholder derivative actions, which are defined by the Rule to mean actions "brought to enforce a *right* of the corporation . . ." (emphasis supplied).

The Court of Appeals held that the cause of action expressed in Section 36(b) was not a derivative action within the meaning of Rule 23.1 (A. 33a, 46a). 692 F.2d at 255, 261. But, ICA Section 36(b) provides that the only shareholder action that may be maintained under that section must be one brought *solely* to enforce a right "on behalf of" the investment company—the precise definition of a derivative action used in Rule 23.1. Thus, unless Rule 23.1 has somehow been rendered inapplicable to actions under Section 36(b), the plain language of Rule 23.1 and Section 36(b) read together mandates a prospective plaintiff's compliance with the demand requirements of Rule 23.1.[22]

The Federal Rules of Civil Procedure were promulgated "to meet the needs of an increasingly complex social organization, for efficient and workable court machinery."[23] Toward

[21] The prescriptions of Rule 23.1 originally were promulgated as Equity Rule 94, 104 U.S. ix (1882), which later became Equity Rule 27, 226 U.S. 656 (1912), and, prior to Rule 23.1, were embodied in former Rule 23(b) of the Federal Rules of Civil Procedure, 308 U.S. 690 (1938). *See, e.g., Ross* v. *Bernhard, supra,* 396 U.S. at 534 n. 4; *Koster* v. *(American) Lumbermens Mutual Casualty Co., supra,* 330 U.S. at 522.

[22] It is axiomatic that, in construing a statute, the starting point is "the language of the statute itself." *See, e.g., Steadman* v. *Securities and Exchange Commission,* 450 U.S. 91, 97, *reh'g denied,* 451 U.S. 933 (1981); *Rubin* v. *United States,* 449 U.S. 424, 429 (1981).

[23] C. Clark & J. Moore, *A New Federal Civil Procedure,* 44 Yale L.J. 387, 387 (1935).

that end, the first of the Federal Rules establishes that those rules shall "govern the procedure in the United States district courts in *all* suits of a civil nature ... [and they] shall be construed to secure the just, speedy, and inexpensive determination of each action." Fed. R. Civ. P. 1 (emphasis supplied).

In recognition of Rule 1's manifest direction, this Court has commanded that all of the Federal Rules are presumptively applicable "[i]n the absence of a *direct expression* by Congress of its intent to depart from the usual course of trying 'all suits of a civil nature' under the Rules established for that purpose ...." *Califano* v. *Yamasaki*, 442 U.S. 682, 700 (1979) (emphasis supplied). A party to a civil action who seeks to abrogate a Federal Rule's applicability, therefore, necessarily bears a heavy burden of proof that such a result was intended.[24] That burden has not been sustained here.

The Court of Appeals held that the prescriptions embodied in Rule 23.1 apply only if the corporation (here, the Fund) is able to assert, in a court, exactly the same cause of action, under exactly the same statute, as is proposed to be asserted by the derivative shareholder plaintiff (A. 29a). 692 F.2d at 254. *Rule 23.1, however, plainly does not set forth such a test.* What the Rule *does* state is that the corporation must have "failed to enforce *a* right which properly may be asserted by it ..." (emphasis supplied). But, this language refers to the *gravamen* of the derivative plaintiff's cause of action—that is, the Rule requires that there must be some properly assertable *right* that

[24] Although Congress has the authority to enact legislation which supersedes conflicting provisions of the Federal Rules of Civil Procedure, a subsequently enacted statute should be so construed as to harmonize with the Federal Rules if that is at all feasible. *See, e.g., Califano* v. *Yamasaki, supra*, 442 U.S. at 700; *Weiss* v. *Temporary Investment Fund, Inc., supra*, 692 F.2d at 936; *Grossman* v. *Johnson, supra*, 674 F.2d at 122-23; *United States* v. *Gustin-Bacon Div., Certain-Teed Products Corp.*, 426 F.2d 539, 542 (C.A. 10), *cert. denied*, 400 U.S. 832 (1970); *Markowitz* v. *Brody*, 90 F.R.D. 542, 549 (S.D. N.Y., 1981); *Untermeyer* v. *Fidelity Daily Income Trust*, 79 F.R.D. 36, 45 (D. Mass.), *vacated on other grounds*, 580 F.2d 22 (C.A. 1, 1978); 7 J. Moore, *Moore's Federal Practice* ¶86.04[4] (2d ed. 1980); Fed. R. Civ. P. 1.

has been breached, the corporation must be able to "assert" such a right (presumably, but not necessarily, in a court of law [25]), and the corporation must have failed to take steps to enforce that right.

Nothing in the language of Rule 23.1 requires, as the court below believed, that the corporation's "right" must "be properly . . . asserted" in a lawsuit that is identical in all respects to the lawsuit the corporation's shareholder proposes to institute derivatively.[26] Under Maryland law, the Fund would have a cause of action, identical *in substance* to the cause of action set forth in ICA Section 36(b), against the Fund's adviser if the Fund believed that it had been charged excessive advisory fees under its contract,[27] and nothing in the ICA would

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[25] In point of fact, the language of Rule 23.1 does not even require that the corporation's rights must be assertable *in a lawsuit*. In a number of early decisions, however, this Court indicated that it would permit a shareholder to institute a derivative action only if the corporation (on whose behalf the derivative action is to be instituted) could have instituted some type of lawsuit to resolve the actions that prompted the commencement of the derivative suit. *See, e.g., Delaware & Hudson Co.* v. *Albany & Susquehanna R.R. Co.*, 213 U.S. 435, 447 (1909).

That requirement, as with other prerequisites to derivative actions, was imposed not to *benefit* a derivative shareholder plaintiff, but rather, to *preclude* abusive and frivolous lawsuits by such shareholders. *Cf. Surowitz* v. *Hilton Hotels Corp., supra*, 383 U.S. at 371; *Hawes* v. *City of Oakland, supra*, 104 U.S. at 452-53. Where, as here, Congress has specifically authorized a shareholder's derivative suit to redress the specific wrongs challenged, there are no equitable considerations that would require a court to inquire whether the corporation itself could have maintained its own lawsuit.

[26] This court has repeatedly recognized, for example, that there is no requirement inherent in Rule 23.1, or otherwise, of absolute symmetry between a shareholder's derivative action and any action the corporation itself might be able to pursue on its own behalf. *See, e.g., Ross* v. *Bernhard, supra*, 396 U.S. at 533-34 (corporate action may be legal although shareholder derivative action is equitable); *Smith* v. *Sperling*, 354 U.S. 91 (1957) (corporation may be party defendant rather than aligned with plaintiff shareholder); *Hawes* v. *City of Oakland, supra*, 104 U.S. at 452 (derivative plaintiff may be able to sue in federal court, but corporation may be limited to state court); *Dodge* v. *Woolsey*, 59 U.S. (18 How.) 331 (1856) (same).

[27] *See, e.g., Feinberg* v. *George Washington Cemetery, Inc.*, 226 Md. 393, 174 A.2d 72, 74 (1961); *Llewellyn* v. *Queen City Dairy, Inc.*, 187 Md. 49, 48 A.2d 322, 326 (1946); *cf. Parish* v. *Maryland & Virginia Milk Producers Ass'n, Inc.*, 250 Md. 24, 242 A.2d 512, 544-45 (1968).

preclude the Fund from asserting such a cause of action under state law.[28] The Court of Appeals' contrary conclusion regarding the standard set forth in Rule 23.1 is predicated not on a fair reading of the language of the Rule, but rather, is based solely upon a misreading of this Court's previous decisions.[29]

Moreover, even if it is assumed, *arguendo*, that an investment company must be able to "assert, in a court, the same action under the same rule of law," as erroneously held by the Court of Appeals, that test is, in any event, satisfied here, since a mutual fund has a cause of action under Section 36(b). For approximately a decade prior to the adoption of the 1970 Amendments to the ICA, the federal courts consistently and repeatedly had recognized the *enforceable* right on behalf of mutual funds not to be charged excessive fees by their investment advisers.[30]

Because Congress *supplemented* this existing right of action in 1970, by expressly authorizing mutual fund shareholders to bring such actions "on behalf of" their mutual funds, however,

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[28] *See Burks* v. *Lasker, supra,* 441 U.S. at 478.

[29] The Court of Appeals relied primarily on this Court's decision in *Delaware & Hudson Co.* v. *Albany & Susquehanna R.R. Co., supra,* 213 U.S. at 447, to support its belief that demand is required only if the corporation can assert the same right as the shareholder derivative plaintiff proposes to assert, in an *identical* lawsuit. But, this Court in *Delaware & Hudson* merely acknowledged that a shareholder who has no personal right of action will not be permitted to commence an action on behalf of a corporation unless his suit is founded on *some* right of action possessed by the corporation. *See also, Ross* v. *Bernhard, supra,* 396 U.S. at 534-35.

[30] *See, e.g., Levitt* v. *Johnson,* 334 F.2d 815, 816-17 (C.A. 1, 1964), *cert. denied,* 379 U.S. 961 (1965); *Brown* v. *Bullock,* 194 F. Supp. 207 (S.D. N.Y.), *aff'd,* 294 F.2d 415 (C.A. 2, 1961) (*en banc*); *Glicken* v. *Bradford,* 35 F.R.D. 144, 146-47 (S.D. N.Y., 1964); *Acampora* v. *Birkland,* 220 F. Supp. 527, 531-32 (D. Colo., 1963); *Kerner* v. *Crossman,* 211 F. Supp. 397, 398 (S.D. N.Y., 1962); *Report of the Securities and Exchange Comm'n on the Public Policy Implications of Investment Company Growth, reprinted in* H.R. Rep. No. 2337, 89th Cong., 2d Sess. 146 (1966); *Mutual Fund Amendments: Hearings Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737, Bills to Amend the Investment Company Act of 1940, the Investment Advisers Act of 1940, and the Securities Exchange Act of 1934,* 91st Cong., 1st Sess. 881 (1969) (hereinafter "*1969 House Hearings*"); *Investment Company Amendments Act 1969: Hearings Before the Senate Comm. on Banking and Currency, on S. 34 and S. 296,* 91st Cong., 1st Sess. 30, 421 (1969) (hereinafter "*1969 Senate Hearings*").

the court below held that Congress must have meant to preclude mutual funds from themselves maintaining such actions (A. 32a-33a). 692 F.2d at 255. This reasoning is a *non sequitur*, and worse, it ignores the recent teachings of this Court.

In 1970, Congress carefully reviewed the cases that had confirmed the existence of a mutual fund's enforceable right not to be charged excessive fees, and determined to *strengthen*, not to weaken, that right by expressly authorizing a mutual fund's *shareholders* to maintain such an action in federal court, and by defining the standards applicable to such an action.[31] In doing so, it is both noteworthy and dispositive that Congress did *not* preclude mutual funds from enforcing such rights themselves.[32]

It simply defies logic, and the recent teachings of this Court, therefore, to believe that, having affirmatively endorsed those cases that had implied an enforceable right on behalf of a mutual fund, and having insisted that the express shareholder remedy it was codifying had to be brought "on behalf of" the mutual fund, Congress affirmatively intended to deny mutual funds the ability to vindicate their own rights in their own names.[33]

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[31] *See, e.g.*, H.R. Rep. No. 2337, *supra*, at 132-47; *1969 Senate Hearings*, *supra*, at 420-21; *1969 House Hearings*, *supra*, at 201-02, 260, 439-40; *Investment Company Act Amendments of 1967: Hearings Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce, on H.R. 9510, H.R. 9511, 90th Cong., 1st Sess. 42-43 (1967) (hereinafter "1967 House Hearings")*; *Mutual Fund Legislation of 1967: Hearings Before the Senate Comm. on Banking and Currency on S. 1659*, 90th Cong., 1st Sess. 20, 1016 (1967) (hereinafter "*1967 Senate Hearings*").

[32] *See, e.g., Herman & MacLean* v. *Huddleston*, ____U.S.____, 103 S. Ct. 683, 689 (1983); *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Curran*, 456 U.S. 353, 102 S. Ct. 1825, 1839 (1982); *Cannon* v. *University of Chicago*, 441 U.S. 677, 694 (1979).

[33] Indeed, application of the four criteria set forth in *Cort* v. *Ash*, 422 U.S. 66, 78 (1975), confirms the propriety of continuing to imply an enforceable right of action by a mutual fund to recover excessive fees. *See Weiss* v. *Temporary Investment Fund, Inc.*, *supra*, 692 F.2d at 934-35; *cf. Grossman* v. *Johnson*, *supra*, 674 F.2d at 120. The court below ignored the tests set forth in *Cort* v. *Ash*, *supra*, 422 U.S. at 78.

The lower court's conclusion—that a shareholder's derivative action under Section 36(b) is somehow not subject to the safeguards normally applicable to all other shareholder derivative suits—is also impossible to square with the genesis, nature and Congressional purposes manifested in the adoption of Section 36(b). Thus, Section 36(b) traces its origins to shareholder actions at common law for corporate waste, which undoubtedly were, and are, derivative within the meaning of Rule 23.1.[34]

By its express terms, Section 36(b) merely defines, for purposes of federal law, what constitutes an actionable breach of fiduciary duty owed to a mutual fund, and it is beyond peradventure of a doubt that a shareholder's action for breach of fiduciary duty is derivative in nature.[35] Section 36(b), accordingly, was not intended to, and most assuredly does not, transform such actions for waste or breach of fiduciary duty from derivative actions to personal claims; rather, the statute was enacted in order to assure the existence of a federal forum, and to articulate federal standards, for the pursuit of this highly traditional derivative cause of action.[36]

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[34] *See, e.g., Smith* v. *Sperling, supra,* 354 U.S. 91; *Weiss* v. *Temporary Investment Fund, Inc., supra,* 692 F.2d at 935 & n. 9; *Lewis* v. *Curtis,* 671 F.2d 779 (C.A. 3), *cert. denied,* ____U.S.____, 103 S.Ct. 176 (1982); *Tanzer* v. *Huffines,* 314 F. Supp. 189 (D. Del., 1970); *Saxe* v. *Brady,* 184 A.2d 602 (Del. Ch., 1962); *Brown* v. *Bullock, supra,* 194 F. Supp. 207; H.R. Rep. No. 2337, *supra,* at 132-149; S. Rep. No. 184, 91st Cong., 1st Sess. 5 (1969), *reprinted in* 1970 U.S. Code Cong. & Ad. News 4897, 4901; H.R. Rep. No. 1382, 91st Cong., 2d Sess. 7 (1970); *1969 House Hearings, supra,* at 794.

[35] *See, e.g., Burks* v. *Lasker, supra,* 441 U.S. at 484; *Koster* v. *(American) Lumbermens Mutual Casualty Co., supra,* 330 U.S. at 522; *Joy* v. *North,* 692 F.2d 880 (C.A. 2, 1982).

[36] *Compare, e.g., Acampora* v. *Birkland, supra,* 220 F. Supp. at 548-49; *and Saxe* v. *Brady, supra,* 184 A.2d at 610; *with Gartenberg* v. *Merrill Lynch Asset Management Fund, Inc.,* 694 F.2d 923, 928 (C.A. 2, 1982); *and Fogel* v. *Chestnutt,* 668 F.2d 100, 111 (C.A. 2, 1981), *cert. denied sub nom., Currier* v. *Fogel,* ____U.S.____, 103 S. Ct. 65, *reh'g denied,* ____U.S.____, 103 S. Ct. 478 (1982); *see generally,* Note, *Mutual Fund Advisory Fees and the New Standard of Fiduciary Duty—Interpreting the 1970 Mutual Fund Act,* 56 Cornell L. Rev. 627 (1971); Comment, *Private Rights of Action Against Mutual Fund Investment Advisers: Amended Section 36 of the 1940 Act,* 120 U. Pa. L. Rev. 143, 158 (1971); *1969 House Hearings, supra,* at 856-58; *1969 Senate Hearings, supra,* at 107, 161-62, 172, 427.

Moreover, even a cursory perusal of the rudiments of a Section 36(b) action demonstrates the derivative nature of the action. A suit under Section 36(b) arises from a contract between the investment company and its investment adviser. The injury alleged is to the mutual fund and, of course, the remedy available to shareholders under Section 36(b) is an equitable one on behalf of the company—an accounting and repayment of excessive fees to the fund.[37]

As in other derivative actions under Rule 23.1, dismissal or settlement of a Section 36(b) action must be approved by the court, generally after notice to other shareholders,[38] and attorneys' fees for successful plaintiffs come from the monies recovered on behalf of the mutual fund.[39] And, the resolution of a shareholder's suit under Section 36(b) is *res judicata*—that is, it effectively ends not only the specific lawsuit involved, it also precludes any other shareholder from commencing or maintaining another action challenging the same advisory fees.[40]

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[37] *See, e.g., In re Gartenberg*, 636 F.2d 16, 18 (C.A. 2, 1980), *cert. denied sub nom., Gartenberg* v. *Pollack*, 451 U.S. 910 (1981); *Markowitz* v. *Moneymart Assets, Inc.*, [1981 Decisions] Fed. Sec. L. Rep. (CCH) ¶98,360 at 92,213 (S.D. N.Y., 1981); *Krasner* v. *Dreyfus Corp.*, 90 F.R.D. 665, 672 (S.D. N.Y., 1981); Note, *Mutual Fund Advisory Fees—Too Much For Too Little?*, 48 Fordham L. Rev. 530, 542 (1980).

[38] *See, e.g., Markowitz* v. *Moneymart Assets, Inc., supra*, [1981 Decisions] Fed. Sec. L. Rep. (CCH) ¶98,360; *Krasner* v. *Dreyfus Corp.*, 500 F. Supp. 36 (S.D. N.Y., 1980); *cf. Ruskay* v. *Waddell*, 552 F.2d 392 (C.A. 2), *cert. denied*, 434 U.S. 911 (1977); *Girsh* v. *Jepson*, 521 F.2d 153 (C.A. 3, 1975); *Newman* v. *Stein*, 464 F.2d 689 (C.A. 2), *cert. denied sub nom., Benson* v. *Newman*, 409 U.S. 1039 (1972); *Norman* v. *McKee*, 431 F.2d 769 (C.A. 9, 1970), *cert. denied sub nom., Isi Corp.* v. *Myers*, 401 U.S. 912 (1971); *Glicken* v. *Bradford, supra*, 35 F.R.D. 144; *Kerner* v. *Crossman, supra*, 211 F. Supp. 397; *see generally*, Annot., 26 A.L.R. Fed. 465 (1976).

[39] *See, e.g., Krasner* v. *Dreyfus Corp., supra*, 90 F.R.D. at 674-75; *cf. Glicken* v. *Bradford, supra*, 35 F.R.D. at 158; *Rome* v. *Archer*, 197 A.2d 49, 57 (Del., 1964).

[40] *See, e.g., Lerner* v. *Reserve Management Co.*, [1981 Decisions] Fed. Sec. L. Rep. (CCH) ¶98,036 (S.D. N.Y., 1981); *cf. Ruskay* v. *Jensen*, 342 F. Supp. 264 (S.D. N.Y., 1972), *aff'd sub nom., Ruskay* v. *Waddell, supra*, 552 F.2d 392; *Rome* v. *Archer, supra*, 197 A.2d at 58; *see generally, Recent Developments*, 45 Fordham L. Rev. 1534, 1540 (1977).

This Court and other courts have acknowledged consistently, and without exception, the derivative nature of a shareholder's action to recover excessive mutual fund advisory fees, both prior [41] and subsequent [42] to the passage of Section 36(b). Put quite simply, until the decision below, no court had ever questioned that an action by a mutual fund shareholder to recover excessive fees and/or for a breach of a fiduciary duty owed to the fund was anything other than derivative.

This consistent judicial recognition of the derivative nature of an action under Section 36(b) is mirrored by the record developed during the Congress' consideration of Section 36(b). That legislative record is replete with references to the derivative character of such a suit.[43] Indeed, at various points during

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[41] *See, e.g., Ross* v. *Bernhard, supra,* 396 U.S. 531; *Kauffman* v. *Dreyfus Fund, Inc.,* 434 F.2d 727 (C.A. 3, 1970), *cert. denied,* 401 U.S. 974 (1971); *Norman* v. *McKee, supra,* 431 F.2d 769, *aff'ing,* 290 F. Supp. 29 (N.D. Cal., 1968); *Levitt* v. *Johnson, supra,* 334 F.2d 815; *Glicken* v. *Bradford, supra,* 35 F.R.D. 144; *Acampora* v. *Birkland, supra,* 220 F. Supp. 527; *Rome* v. *Archer, supra,* 197 A.2d 49; *Saxe* v. *Brady, supra,* 184 A.2d 602; *Meiselman* v. *Eberstadt,* 170 A.2d 720 (Del. Ch., 1961).

[42] *See, e.g., Burks* v. *Lasker, supra,* 441 U.S. 471; *Gartenberg* v. *Merrill Lynch Asset Management, Inc., supra,* 694 F.2d 923; *Weiss* v. *Temporary Investment Fund, Inc., supra,* 692 F.2d 928; *Grossman* v. *Johnson, supra,* 674 F.2d 115; *Jerozal* v. *Cash Reserve Management, Inc.,* [Current Decisions] Fed. Sec. L. Rep. (CCH) ¶99,019 (S.D. N.Y., 1982); *Blatt* v. *Dean Witter Reynolds Intercapital Inc.,* 528 F. Supp. 1152 (S.D. N.Y., 1982); *Markowitz* v. *Moneymart Assets, Inc., supra,* [1981 Decisions] Fed. Sec. L. Rep. (CCH) ¶98,360; *Markowitz* v. *Brody, supra,* 90 F.R.D. 542; *Krasner* v. *Dreyfus Corp., supra,* 90 F.R.D. 665, 500 F. Supp. 36; *Lerner* v. *Reserve Management Co., supra,* [1981 Decisions] Fed. Sec. L. Rep. (CCH) ¶98,036; *Wolfson* v. *Cooper* [1976 Decisions] Fed. Sec. L. Rep. (CCH) ¶95,634 (S.D. N.Y., 1976); *Boyko* v. *Reserve Fund, Inc.* 68 F.R.D. 692 (S.D. N.Y., 1975).

[43] *See, e.g.,* H.R. Rep. No. 1382, *supra,* at 78, 83; *1969 House Hearings, supra,* at 202; *1969 Senate Hearings, supra,* at 156; *1967 House Hearings, supra,* at 42; 116 Cong. Rec. 33,286-87 (1970); *see also 1969 House Hearings, supra,* at 796-98 (Testimony of Judge Henry J. Friendly); *1969 Senate Hearings, supra,* at 185, 420-21.

So universal was the acknowledgment that an action under Section 36(b) would be derivative, that the late Abraham Pomerantz, with whom the plaintiff's attorney in this action practiced law for many years, testified:

> Mr. Pomerantz. Perhaps I should say at the outset that . . . over the past decade I have been quite preoccupied with my associate.

(footnote continues)

the legislative deliberations leading to the adoption of Section 36(b), various members of Congress expressed concern about the potential abuses that might inhere in the creation of an express shareholder derivative action; *Section 36(b) was adopted only after Congress was satisfied that the Federal Rules of Civil Procedure generally, and the provisions of Rule 23.1 in particular, would minimize the danger of so-called strike suits.*[44]

C. Application Of The Demand Requirement To Actions Under Section 36(b) Is Necessary To Effectuate The Purposes Of The Investment Company Act.

The Court of Appeals predicated its decision upon its belief that requiring adherence to the demand requirement would *never* be a productive exercise (A. 41a). 692 F.2d at 259. Despite the fact that Congress went to great lengths in 1970 to reinforce the obligations and powers of the independent directors of an investment company—efforts noted with great approval by this Court just a few years ago, in *Burks* v. *Lasker, supra,* 441 U.S. at 483-85—the Court of Appeals denigrated Congress' efforts, stating that they "cannot seriously be expected" to achieve their intended result (A. 41a). 692 F.2d at 259.

The 1970 Amendments to the Investment Company Act, however, were intended, as this Court has observed, "to strengthen . . . the independence of" the outside directors of investment companies. *Burks* v. *Lasker, supra,* 441 U.S. at 482. As this Court there noted:

> [T]he structure and purpose of the Investment Company Act indicated that Congress entrusted to the

(footnote continued)

> Richard Mayer [sic], in bringing derivative actions on behalf of mutual funds against their respective advisers and managers . . . . [*T*]*he law says to us that if you represent a shareholder of a fund, the action that you bring, the derivative action is indeed brought "on behalf of the corporation involved."*

1969 House Hearings, supra, at 765-66 (emphasis supplied).

[44] *See, e.g., 1969 House Hearings, supra,* at 149, 201, 860; *1969 Senate Hearings, supra,* at 30, 156; H.R. Rep. No. 1382, *supra,* at 64.

> independent directors of investment companies, . . . the *primary* responsibility for looking after the interests of the funds' shareholders.

441 U.S. at 484-85 (emphasis supplied).

Nothing in Section 36(b) compels a different conclusion. As the legislative history of that section manifests, Congress most assuredly did not intend to weaken or denigrate the powers of the independent directors of a mutual fund to act in the best interests of the fund's shareholders, and in accordance with state law:

> [Section 36(b)] is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors. Indeed, this section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation. The section is not intended to shift the responsibility for managing an investment company . . . from the directors . . . to the judiciary.

S. Rep. No. 184, *supra,* at 4903.

The decision below is, therefore, diametrically inconsistent with the carefully-enacted statutory scheme of the ICA. Section 10 of the Act requires a certain percentage of disinterested board members of an investment company. 15 U.S.C. § 80a-10. Pursuant to Section 15, those board members are entrusted with certain, critical, supervisory functions, including review, approval and, if necessary, termination, of underwriter and advisory contracts. 15 U.S.C. § 80a-15.

In carrying out these functions, the directors must request and study all information necessary to their evaluation of such contracts. 15 U.S.C. § 80a-15(c). As with all other corporate directors, investment company directors are forbidden from engaging in actions or practices which constitute a breach of fiduciary duty involving personal misconduct. 15 U.S.C. § 80a-35.

The Second Circuit's opinion ignores these Congressionally-delegated responsibilites by repudiating the demand requirement and bypassing director participation in matters of crucial interest to a mutual fund. It justified this result by asserting that a mutual fund's independent directors can *never* be truly independent (A. 41a-46a). 692 F.2d at 259-61. The decision below thus evidences the utmost cynicism; in effect, the Court of Appeals dispensed with demand because, *in its view*, independent directors will *never* exercise independent judgment, and shareholders can *never* be persuaded that litigation may not be in their funds' best interests. These notions, which are contrary to Congress' design, were effectively dispelled by this Court in *Burks* v. *Lasker:*

> [T]he Court of Appeals [for the Second Circuit] was also of the view that mutual fund directors can never be truly disinterested .... While lack of impartiality may or may not be true as a matter of fact in individual cases, it is not a conclusion of law required by the Investment Company Act. Congress surely would not have entrusted such critical functions as approval of advisory contracts and selection of accountants to the statutorily disinterested directors had it shared the Court of Appeals' view that such directors could never be "disinterested" where their codirectors or investment advisers were concerned.

441 U.S. at 485 n. 15.

The capacity of a mutual fund's independent directors to perform the "host of special responsibilities" Congress has assigned them [45] is seriously undermined by a holding that a mutual fund shareholder need *never* comply with the demand requirement embodied in Rule 23.1 prior to bringing a formal complaint regarding excessive fees under an advisory contract.

Quite to the contrary, upon early notice of such a grievance—through shareholder demand—a mutual fund's board of directors can seek to obtain a beneficial resolution of the

[45] *Burks* v. *Lasker, supra*, 441 U.S. at 483.

dispute, if the dispute is real. Indeed, the directors, through the contractual leverage of the Act's prescriptions, may very well be able to obtain a more satisfactory settlement than the judgment permitted under the one-year fee recovery limitation set forth in Section 36(b).[46]

As summarized by the court in *Weiss* v. *Temporary Investment Fund, Inc., supra,* 692 F.2d at 942 n. 16, mutual fund directors can respond to a timely demand by a shareholder in a variety of ways, including:

> (1) negotiating a rebate of fees, (2) satisfying the shareholder that the fees are reasonable in terms of the investment services provided, (3) persuading the shareholder that litigation would adversely affect shareholders' interests, (4) accepting the demand and instituting suit, or (5) refusing the demand.

When weighed against the above-described benefits, it is difficult to comprehend what burdens a mutual fund shareholder will suffer by complying with the demand requirement.[47]

In short, as this Court noted in *Burks* v. *Lasker, supra,* 441 U.S. at 485:

> It would have been paradoxical for Congress to have been willing to rely largely upon [a mutual fund's independent directors] as "watchdogs" to protect shareholder interests and yet, where the "watchdogs" [seek to do] precisely that, require that they be totally muzzled.

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[46] *See* p. 3, n. 4, *supra.*

[47] The Court of Appeals suggested, without citation, that the delay caused by the demand process might preclude a full recovery of excessive fees in certain cases because of the one-year limitation on fee recoveries contained in Section 36(b)(3) (A. 47a-48a). 692 F.2d at 261-62. But, such a concern is unrealistic. Courts commonly accept limitations upon the time in which a board of directors must respond to a demand. If the board fails to act within a reasonable period of time, the shareholder is free to proceed with the litigation. *See, e.g., Weiss* v. *Temporary Investment Fund, Inc., supra,* 692 F.2d at 938; *Grossman* v. *Johnson, supra,* 674 F.2d at 122; *Mills* v. *Esmark, Inc.,* 91 F.R.D. 70 (N.D. Ill., 1981); *Zilker* v. *Klein,* 510 F. Supp. 1070 (N.D. Ill., 1981).

Just as in *Burks* v. *Lasker*, the decision of the court below would render the independent directors of the Fund "totally muzzled." In painstakingly enacting and amending the Investment Company Act, Congress never intended such a result.[48]

[48] The Court of Appeals justified its departure from the teachings of this Court in *Burks* v. *Lasker*, by relying upon the *dictum* in that decision that the independent directors of a mutual fund might not be able to terminate a derivative action brought pursuant to Section 36(b) (A. 46a). 692 F.2d at 261, *quoting*, 441 U.S. at 484.

It is not clear that independent mutual fund directors lack the ability to terminate Section 36(b) actions. This Court, in assuming (without deciding) that Congress intended to prevent director termination of such suits, relied upon the language of Section 36(b)(2); that section instructs federal courts to give appropriate consideration to the fact that a challenged advisory contract was approved by a mutual fund's board of directors or ratified by the fund's shareholders. The legislative history of that section demonstrates, however, that Congress was not concerned with director dismissal of a shareholder derivative action *after* demand; rather, Congress intended to preclude automatic judicial dismissal of such an action (absent proof of waste) on the ground that the advisory contract in question had, *prior* to becoming effective, been approved by the board or ratified by shareholders pursuant to ICA Section 15. *See, e.g.*, S. Rep. No. 184, *supra*, at 4910; H.R. Rep. No. 1382, *supra*, at 37; *1969 House Hearings*, *supra*, at 696, 784-89; *1967 House Hearings*, *supra*, at 43, 105-06; H.R. Rep. No. 2337, *supra*, at 145-46; *1967 Senate Hearings*, *supra*, at 21.

Even if independent directors cannot automatically terminate a Section 36(b) action, however, the demand requirement, and its salutory purposes, still serve the important public policies discussed in the text above. *See, e.g.*, *Weiss* v. *Temporary Investment Fund, Inc.*, *supra*, 692 F.2d at 940-41; *Grossman* v. *Johnson*, *supra*, 674 F.2d at 121.

CONCLUSION

For the foregoing reasons, the decision of the Court of Appeals should be reversed.

Respectfully submitted,

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April 21, 1983

CERTIFICATE OF SERVICE

I, Harvey L. Pitt, a member of the Bar of the Supreme Court of the United States, hereby certify that I have caused (3) copies of the foregoing motion and brief to be served by certified mail this 21st day of April, 1983, upon the following:

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